CANTILO & BENNETT, L.L.P.

ATTORNEYS & COUNSELORS
A Texas Registered Limited Liability Partnership
Comprised of Professional Corporations

7501 North Capital of Texas Highway
Building C, Suite 200
Austin, Texas 78731
www.cantilobennett.com

Telephone: (512) 478-6000 **Facsimile: (512) 404-6550**

November 26, 2003

VIA E-MAIL and REGULAR MAIL

The Honorable James T. Odiorne
Deputy Insurance Commissioner
Company Supervision
Washington Office of the Insurance Commissioner
5000 Capitol Boulevard
Tumwater, Washington 98501

Re: PREMERA; Our File No. 61000-001

Dear Mr. Odiorne:

Cantilo & Bennett, L.L.P. ("C&B") has been engaged by the Office of the Insurance Commissioner of the State of Washington (the "OIC") to assist in the evaluation of a proposal by the Premera Group ("PREMERA") to change the ultimate controlling entity of PREMERA's members, which are regulated by the Insurance Commissioner of the State of Washington (the "Commissioner") pursuant to Title 48 ("Washington Insurance Code") of the Revised Code of Washington ("RCW"). Transmitted with this letter is a report containing C&B's analysis of PREMERA's stock ownership and executive compensation plans (the "Executive Compensation Report") at the request of the OIC. This letter explains the context of this analysis and summarizes C&B's views based on the Proposed Transaction as currently constituted, the information made available thus far, and the executive compensation reports submitted by other consultants engaged by the OIC. Thus, this letter should serve as an executive summary (the "Executive Summary") of C&B's Executive Compensation Report (referred to collectively as "C&B's Analysis"). Throughout C&B's Analysis, PREMERA's proposed conversion shall be referred to as either the "Proposed Transaction" or the "Transaction." The Executive Compensation Report explains the facts and information reviewed by C&B, the context of the analysis, and important assumptions and qualifications regarding C&B's conclusions.

ISSUES CONSIDERED

On October 27, 2003, C&B submitted to the OIC an analysis of various issues (the "Final Report") that were requested to be reviewed as part of C&B's engagement. As part of the Final Report, C&B reviewed information and materials that were available as of October 15, 2003, pursuant to the Commissioner's Sixteenth Order. On October 17, 2003, PREMERA made what essentially amounted to a material amendment of the Form A by submitting Stock Ownership Plans ("SOP" or the "Plans") that it proposed to adopt upon approval of the Transaction.[1] As will be seen, those Plans arguably are germane to two issues addressed in C&B's Final Report: (1) whether the Proposed Transaction is fair to policyholders,[2] health care providers, and the public, and (2) whether there exist conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees. The OIC has, thus, requested C&B to analyze the SOP to determine the fairness of the plans, and to determine whether certain conflicts of interest or self-dealing exist. This Executive Summary must be read together with the Executive Compensation Report and the Final Report, and the OIC should not rely solely upon this Executive Summary.

LIMITATIONS & QUALIFICATIONS

C&B's Analysis is issued exclusively to the OIC, and only the OIC may rely upon C&B's Analysis. C&B's Analysis may not be quoted, in whole or in part, without C&B's written consent. Except to the extent expressly agreed upon as part of the engagement, C&B will have no obligation to "bring down" or update the Executive Compensation Report after it is first issued.

In conducting its analysis, C&B has relied on the sufficiency and accuracy of the information provided by PREMERA, the OIC, the OIC's other consultants or advisors, and other sources. The Executive Compensation Report evaluates the transaction based on information gathered and analyzed through October 17, 2003. The document regarding the SOP provided by PREMERA, which has been reviewed by C&B and the other consultants, is provided in Appendix I. In addition, C&B and the other consultants have attended numerous meetings, and participated in numerous telephone calls, with PREMERA's management, key employees, counsel, and its advisors, as well as with state officials and their advisors, which have touched on some of the issues analyzed herein. Moreover, as part of its analysis, C&B has reviewed the executive compensation reports provided by the other consultants and has incorporated selected excerpts in this Executive Compensation Report. This Executive Compensation Report should be read together with the reports of the other consultants.

C&B has made diligent efforts to request, and to assist other OIC advisors in requesting and obtaining, from PREMERA, all of the information necessary for an adequate review of the relevant issues raised by the Proposed Transaction. Although PREMERA appears to have made substantial efforts to provide the information requested, many seemingly important documents have not been provided, primarily due to PREMERA's claims of attorney-client privilege or the doctrine of work product. Judge George Finkle, the Special Master appointed by the Commissioner, conducted *in camera* reviews of these documents and issued opinions on August 22, 2003, and September 8,

[1] The OIC and consultants had requested these plans approximately one year ago.

[2] The terms "policyholder" and "subscriber" may be used interchangeably or together throughout C&B's Analysis.

2003, which sustained a majority of PREMERA's claims. The applicability of the Executive Compensation Report is limited to the extent that the materials withheld, if produced, would have altered C&B's conclusions.

Many of the issues considered in the Executive Compensation Report relate to prospective events and anticipated conduct and consequences following the Proposed Transaction's hypothetical implementation. C&B has made assumptions regarding these matters that it believes are reasonable in light of the information provided by PREMERA and other sources. Where relevant, these assumptions are identified in the Executive Compensation Report. If prospective events or anticipated conduct differ materially from that which is assumed in the Executive Compensation Report, the observations and recommendations provided herein may be less applicable, or inapplicable altogether.

To the best of C&B's knowledge, no direct legal precedent exists in Washington for the analysis of many of the pertinent issues regarding the SOP. Due to the paucity of specific case law in this and other jurisdictions, as well as the unique nature of the issues to be opined upon, a substantial portion of the Executive Compensation Report is based on analogous statutes and case law from this and other jurisdictions, as well as C&B's general experience in these areas. To the best of C&B's knowledge and experience, the Executive Compensation Report provides a reasonable evaluation of the relevant issues. The Executive Compensation Report is based on the law as it existed at the time of the analysis. There can be no assurance that any of the relevant law will not change prior to the implementation of the Proposed Transaction, and the Executive Compensation Report may be less applicable, or inapplicable, to the extent of such changes.

SUMMARY OF C&B'S CONCLUSIONS

A summary of C&B's conclusions is presented below. Undefined terms are later defined in the Executive Compensation Report. PREMERA proposes to adopt an equity incentive plan upon the Transaction's approval. The Plans provide for several types of additional compensation as follows: (1) Stock Options, (2) Stock Grants, (3) Stock Appreciation Rights, and (4) Performance Units. If the Commissioner finds that the Proposed Transaction arose out of self-dealing or a conflict of interest, or may otherwise not be in the public interest, then the Transaction may be disapproved.

PREMERA has not advised with specificity how it proposes to implement the SOP, if the conversion is approved, and what benefits will be awarded upon such implementation. However, it has provided some guidance in the form of a report from its consultants, which C&B assumes in this report to be indicative of the SOP's likely implementation.

In general, concerns about executive compensation generally, and the SOP in particular, arise in the context of two key issues. Have management and the board of directors been induced to pursue the conversion in the hope or expectation of personal gain, to the detriment of other preferable criteria? If implemented, will the SOP create incentives to conduct the business of the converted companies in a manner inconsistent with the interests of policyholders, insureds, and the public?

As to the first issue, the record as to the role actually played by the SOP in the deliberations of management and the board is simply inconclusive. Indeed, C&B has not been presented sufficient evidence to compel a conclusion that the conversion is motivated primarily, or even disproportionately, by the hope of personal gain. The expectation that the success of the company will result in personal economic rewards is the gravamen of our capitalist system. Thus, C&B does not opine that the mere existence of that expectation creates an impermissible conflict of interest. Rather, rejection of the transaction on these grounds would be justified if it were evident that management and the board elevated their expected personal gain above the protection of the policyholder and other interests they were charged with fulfilling. Because the documents produced by PREMERA do not include many of those memorializing those deliberations, there is not sufficient information to ascertain whether or not that actually occurred.

As to the second issue, it is difficult at best to predict how management will conduct the business of the company after conversion. For purposes of this report, however, it may be sufficient to ascertain whether the SOP do, or might, create an incentive to promote another interest at the expense of policyholders, insureds, and the public. Again, there is insufficient information to state with precision what management intends to do. But the SOP and related materials do permit the Commissioner to determine what is possible, and what seems probable at this juncture. What they demonstrate is that the Plans are structured so as to provide substantial flexibility in the granting of valuable equity-based benefits. However, the indications contained in Mercer's work, as consultants for PREMERA, suggest that management does not now contemplate awards that are grossly excessive in comparison to those accorded by other relevant companies. From the Commissioner's perspective, therefore, a source of concern should be what is possible under the SOP, rather than what PREMERA is suggesting currently that it intends to do.

In the analysis of the proposed Plans, it is important to note that the value of benefits that can be awarded depends almost entirely on increases in the trading price of the stock <u>after</u> the award. The grants are intended precisely to reward such increases. Specific concerns about the terms of the Plans include the following:

1. Equity Incentive Plan - General Provisions

- The absence of oversight over the decisions of the Compensation Committee (the "Committee") may result in potentially excessive Grants, or Grants with extremely favorable terms, for favored key executives shortly after the conversion.

- The absence of limitations as to the number of grants to any individual may result in excessive grants to certain executives or Board Members during the first two years, and thereafter.

- After the initial two-year limitations period, the potential exists for New PREMERA's management, which will effectively have voting control over the Foundation Shareholder, to increase the share reserve in order to compensate for any restrictions applicable during the initial two-year period.

2. Options

- An individual could potentially receive half of the value of all Stock Options granted to him or her by the end of the second year following the conversion. Any decision by the Committee to remove the vesting provisions at the end of the two-year restriction period could enable that individual to receive up to 100 percent of the options.

- The retirement/termination provisions envision accelerated vesting of the Stock Options for executives and Board Members. Some executives who have satisfied, or will soon satisfy, the qualifications for retirement could, in effect, retire shortly after the conversion, at a time when the Stock Options will be fully vested. Likewise, those Board Members who cannot serve another term will have the opportunity to have their options fully vested shortly after the conversion.

3. Stock Grants

- The Committee is granted broad discretion to determine what, if any, restrictions to impose upon, and remove from, the common stock that it grants. These restrictions may include the achievement of performance goals for employees, or the completion of a certain period of service for Board Members. There are no minimum restrictions that must be imposed upon the Stock Grants, and all restrictions may be removed at the Committee's discretion.

4. Stock Appreciation Rights

- Stock Appreciation Rights can be granted in tandem with Stock Options or on a stand-alone basis. Stock Appreciation Rights granted in tandem with Stock Options allow the holder essentially to receive in cash the difference between the fair market value of the common stock underlying the Stock Option and the exercise price. Stock Appreciation Rights granted on a stand-alone basis allow the holder to receive the difference between the fair market value of the common stock on the exercise date and the fair market value of the common stock on the grant date. There is no underlying equity security issued for Stock Appreciation Rights although their value is equity based. That is, the equity underlying the Stock Appreciation Rights is what is known as "phantom stock." Interestingly, the limitations imposed by PREMERA in Exhibit G-10 apply only to equity-based incentives. Thus, there are no limitations on the amount of Stock Appreciation Rights that may be granted.

5. Performance Units

- Performance Units allow the holder to receive Performance Shares or cash when certain performance goals established by the Committee are satisfied. The Committee can alter the terms of the Performance Units at any time. The plan does not prevent the Committee from lowering performance expectations during times when management has not achieved its performance goals, thereby permitting the pay-out of these Grants to be triggered despite the lack of actual justification in performance. Moreover, like Stock Appreciation Rights, Performance Units payable in cash are not affected by the limitations in Exhibit G-10.

6. Compensation

- According to PricewaterhouseCoopers LLP ("PwC"), two of PREMERA's top five executives are being paid above market levels. But, PwC notes that the additional equity-based compensation to be received by management and Board Members are reasonable as compared to publicly-traded health insurers.

- Nonetheless, management stands to gain between a [ ] percent increase in compensation, totaling approximately [ ] in the aggregate. Although these significant increases in compensation may raise doubts as to the true motivation behind the Transaction, these additional equity-based incentives are typically required by the public market in order to align management's interests with the maximization of share value. Therefore, in order to maximize share value for the Foundation Shareholder, this additional equity-based compensation may be in the public interest.

PROPRIETARY MATERIAL REDACTED

In short, there is insufficient information to determine whether management and the board were induced improperly by the expectation of personal gain in deciding to convert. Nor does the information produced by PREMERA indicate that management or the board intends to award unreasonable equity-based benefits. But the SOP are structured so as to provide great flexibility that would make it possible to award stock options and other grants of substantial value in a relatively short time. Undoubtedly, the prospect of these awards, the value of which depends primarily on the increase of the company's stock price, would induce management to conduct the company's affairs so as to maximize profitability and investor satisfaction.

Respectfully,

CANTILO & BENNETT, L.L.P.

Enclosure

EXECUTIVE COMPENSATION REPORT OF CANTILO & BENNETT, L.L.P.

November 26, 2003

An analysis of the

FORM A

STATEMENT REGARDING THE ACQUISITION
OF CONTROL
OF A DOMESTIC HEALTH CARRIER AND A
DOMESTIC INSURER

Premera Blue Cross, States West Life Insurance Company, LifeWise Health Plan of Washington, LifeWise Health Plan of Oregon, Inc., Premera Blue Cross Blue Shield of Alaska, and MSC Life Insurance Company direct or indirect affiliates of

PREMERA

BY

[New PREMERA Corp.]

Filed with the Insurance Commissioner of the State of WASHINGTON, the ALASKA Division of Insurance, and the OREGON Insurance Division

Dated: September 17, 2002

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EXECUTIVE COMPENSATION REPORT OF CANTILO & BENNETT, L.L.P.

I. INTRODUCTION

CANTILO & BENNETT, L.L.P. ("C&B") has been engaged by the Office of the Washington Insurance Commissioner ("OIC") to assist in the evaluation of a proposal by PREMERA to convert from a nonprofit corporation to a for-profit corporation, largely by changing the ultimate controlling entity of PREMERA's members, which are regulated by the Commissioner pursuant to the Washington Insurance Code. Upon the conversion, PREMERA intends to conduct an initial public offering ("IPO"). As part of the IPO and the conversion, PREMERA intends to adopt Stock Ownership Plans ("SOP" or the "Plans"), which provide the ability to grant different types of equity-based compensation upon or following implementation of PREMERA's proposed conversion (the "Proposed Transaction" or the "Transaction"). On October 27, 2003, C&B submitted a final report to the OIC addressing various issues with respect to the Proposed Transaction based on information that was available as of October 15, 2003. On October 17, 2003, PREMERA submitted its Stock Ownership Plans, which are attached in Appendix I.[1] The OIC has requested that C&B evaluate the SOP and submit an additional report based on that review. The request for an evaluation of the SOP was not tied directly to any aspect of the issues on which C&B has been asked to provide reports of opinions, nor to any of the statutory criteria by which the Commissioner will be guided in determining whether to reject the conversion application. However, it is evident that the SOP are most relevant to a specific issue as to which C&B has been asked to opine: whether there exist conversion-related self-dealing and conflicts of interest for PREMERA's officers and trustees.

As C&B's engagement was structured, prior to commencement of this evaluation, areas of analysis were segregated between two hypothetical phases, Stage One and Stage Two. As the review of the Proposed Transaction evolved, the distinctions between Stage One and Stage Two were found to be less meaningful, and a substantial portion of the issues in the second phase were analyzed along with those in the first phase. The SOP might affect materially the conclusions that were developed in the Final Report with respect to two issues: (1) whether the Proposed Transaction is fair to policyholders, health care providers, and the public (Stage One); and (2) whether

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[1] *See* Letter from John P. Domeika, General Counsel, PREMERA, to James T. Odiorne, Deputy Insurance Commissioner, OIC (October 17, 2003) (on file with C&B) (stating that the attachment to the letter includes two documents: (1) PREMERA's Equity Incentive Plan and ancillary agreements referred to therein) (hereinafter the "Plan"); and (2) Mercer Human Resource Consulting Presentation (hereinafter the "Mercer Presentation") [CONFIDENTIAL].

conversion-related self-dealing and conflicts of interest of PREMERA's officers and trustees exists (Stage Two). This report will focus on analysis of the SOP in the context of two issues. Have management and the board of directors been induced to pursue the conversion in the hope or expectation of personal gain, to the detriment of other preferable criteria? If implemented, will the SOP create incentives to conduct the business of the converted companies in a manner inconsistent with the interests of policyholders, insureds, and the public? The answers to these questions would be material to the determination by the Commissioner both as to fairness to policyholders and the public and as to the possibility of self-dealing or conflicts of interest.

This Executive Compensation Report should be read together with the Executive Summary with which it is submitted, and the conditions and defined terms in that summary are hereby expressly incorporated into this Executive Compensation Report. Some footnotes include citations to certain information that PREMERA or others have identified as being confidential. However, C&B has not analyzed the sufficiency of the assertions of confidentiality under applicable law. This Executive Compensation Report is divided into three sections. This first section introduces the Executive Compensation Report. Section II provides a detailed analysis of the relevant issues. Section III summarizes the conclusions developed in this Executive Compensation Report.

II. DISCUSSION

A. Holding Company Acts

Under the Holding Company Acts,[2] the Commissioner is required to approve the Transaction unless he makes one of the following six fact-findings: (1) after the change of control, the domestic health carrier would not be able to satisfy a domestic health carrier's registration requirements; (2) there is substantial evidence that the acquisition would substantially lessen competition or tend to create a monopoly in insurance in Washington; (3) the acquiring party's financial condition is such as might jeopardize the health carrier's financial stability or prejudice its subscribers' interest; (4) the plans or proposals that the acquiring party has to liquidate the specific named health carrier, sell its assets, consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management are unfair and unreasonable to the health carrier's subscribers, and not in the public interest; (5) the competence, experience, and integrity of those persons who would control the health carrier's operations are such that it would not be in the interest

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[2] In a change of control under Washington law, an analysis is required of the following: (1) RCW Chapter 48.31B, the "Insurer Holding Company Act" ("IHCA"), and (2) RCW Chapter 48.31C, the "Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations" ("HHCA"). (The IHCA and the HHCA are collectively referred to throughout this Executive Compensation Report as the "Holding Company Acts.") The IHCA applies to domestic insurer acquisitions, and the HHCA applies to acquisitions of both domestic health care service contractors and health maintenance organizations (these contractors and organizations are referred to collectively by the HHCA as "domestic health carriers"). Both the IHCA and the HHCA apply to the Proposed Transaction because PREMERA's subsidiaries include both domestic health carriers and insurers.

of the health carrier's subscribers, and of the public, to permit the acquisition of control; or (6) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.[3]

The analysis of the Stock Ownership Plans contained in this Executive Compensation Report may be found by the Commissioner to be germane to several of the considerations. Fundamentally, it may affect a determination of fairness of the Proposed Transaction to policyholders and the public interest.[4] The Commissioner might also find it instructive as to the competence, experience, and integrity of those persons who would control the health carrier's operations. Most specifically, however, it may be deemed relevant to whether there exists any conflicts of interest, or whether PREMERA's decision makers engaged in self-dealing.

B. Potential Effect of the Proposed Stock Ownership Plans

In the context of Blue Cross conversions and similar transactions, substantial attention is often devoted to management compensation and incentive or bonus plans. Recognizing that pre-conversion the company typically is deemed to belong to the public, there is often concern that management will attempt to reap rewards for the value of the company as part of the conversion. There tends to be less resistance to incentive plans designed to reward management reasonably for successful performance after conversion. Indeed, public investors typically prefer that management's interest be "aligned" with their own through programs that reward officers and directors when the value of the stock increases. For regulators scrutinizing proposed conversions, a common challenge is assuring that bonus or incentive plans reward future performance rather than value accumulated before the conversion, or simply employment at the time of conversion.

Generally, the SOP proposed by PREMERA are designed to reward post-conversion performance. As will be seen, however, in some instances they may effectively reward being employed (or a director) at the time of the conversion. The Plans provide for several types of additional compensation as follows: (1) Stock Options, (2) Stock Grants, (3) Stock Appreciation Rights, and (4) Performance Units. In the analysis of the proposed Plans, it is important to note that the value of the first three of these benefits depends almost entirely on increases in the trading price of the stock <u>after</u> the award. The grants are intended precisely to reward such increases. Though the terms of awards may differ substantially, eventually the recipient generally is treated effectively as if he or she had bought, at its trading price on the award date, the amount of stock awarded or subject to options under the Plans. An award has value if the recipient can then sell (or be treated as if he or she had sold) the stock at a higher price on a later date, which occurs only when the

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[3] *See* RCW 48.31C.030(5)(a)(i), (5)(a)(ii), (5)(a)(ii)(C)(I)–(IV) (enumerating the six potential disqualifying findings with respect to a domestic health carrier under the HHCA); *see also* RCW 48.31B.015(4)(a)(i)–(vi) (enumerating the same with respect to a domestic insurer under the IHCA).

[4] A detailed analysis of the phrase "public interest" is found in the Final Report.

market price of the stock increases. As intended, therefore, these Plans align the interests of recipients with those of other stockholders.

PREMERA has not advised with specificity how it proposes to implement the SOP, if the conversion is approved, and what benefits will be awarded upon such implementation. However, it has provided some guidance in the form of a presentation by its consultants, which C&B assumes in this report to be indicative of the SOP's likely implementation. See the "Proposed Equity Strategy" prepared by Mercer Human Resource Consulting ("Mercer"), analyzed below.

As noted above, the SOP give rise to two key issues. Have management and the board of directors been induced to pursue the conversion in the hope or expectation of personal gain, to the detriment of other, preferable, criteria? If implemented, will the SOP create incentives to conduct the business of the converted companies in a manner inconsistent with the interests of policyholders, insureds, and the public?

As to the first issue, the record as to the role actually played by the SOP in the deliberations of management and the board is simply inconclusive. Many of the documents that might have shed light on this issue might be contained among those withheld on grounds of privilege before the SOP was provided to the OIC and its consultants. Thus, C&B has not been presented sufficient evidence to compel a conclusion that the conversion is motivated primarily, or even disproportionately, by the hope of personal gain. The expectation that the success of the company will result in personal economic rewards is, of course, consistent with core principles of a free market economy. Thus, the mere existence of that expectation need not compel the conclusion that there was an impermissible conflict of interest. Rather, rejection of the transaction on these grounds would be justified if it were evident that management and the board elevated their expected personal gain above the protection of the policyholder and other interests they were charged with fulfilling. Because the documents produced by PREMERA do not include many of those memorializing those deliberations, there is not sufficient information to ascertain whether or not that actually occurred.

As to the second issue, it is difficult at best to predict how management will conduct the business of the company after conversion. Indeed, even management's current plans are likely to yield over time to the exigencies created by market and economic developments. For purposes of this report, however, it may be sufficient to ascertain whether the SOP do, or might, create an incentive to promote another interest at the expense of policyholders, insureds, and the public. As will be seen, even though there may not be enough information to state with precision what management intends to do, the record may enable the Commissioner to determine what is possible, and what seems probable at this juncture. What available information demonstrates is that the Plans are structured so as to provide substantial flexibility in the granting of valuable equity-based and performance-related benefits. To be sure, the indications contained in Mercer's work (if they are assumed to manifest management's intentions) suggest that management does not now contemplate awards that are grossly excessive in comparison to those accorded by other relevant companies.

From the Commissioner's perspective, therefore, the principal source of concern should be what is possible under the SOP, rather than what PREMERA is suggesting currently that it intends to do.

C. Equity Compensation Plans[5]

1. Structure

PREMERA has provided for the following four types of equity-based compensation ("Grants") to its management, employees, and members on its Board of Directors (the "Board" or "Board Members"): (1) Stock Options, (2) Stock Grants, (3) Stock Appreciation Rights, and (4) Performance Units/Shares. PREMERA's Equity Incentive Plan (the "EIP") is the agreement that provides general provisions that govern the Grants. In addition, PREMERA has provided agreements governing each type of Grant. PREMERA has also incorporated by reference each of the limitations on equity compensation that was provided as Exhibit G-10 to the Form A, entitled "Description of Stock Ownership Plans,"[6] as summarized in Section II.C.3. Lastly, PREMERA has provided the presentation of Mercer Human Resource Consulting ("Mercer") to PREMERA's Compensation Committee delivered on October 17, 2003, entitled "Proposed Equity Strategy," as analyzed in Section II.D.6. In addition to the following observations about the EIP and the SOP, The Blackstone Group ("Blackstone") and PricewaterhouseCoopers LLP ("PwC") have identified key provisions which they believe are either consistent or inconsistent with other comparable conversions as indicated in their reports.

2. Equity Incentive Plan - General Provisions

PREMERA proposes to adopt the EIP upon the Transaction's approval. This plan provides for several types of compensation mechanisms as follows: (1) Stock Options, (2) Stock Grants, (3) Stock Appreciation Rights, and (4) Performance Units. The structure or elements of the EIP give rise to a number of concerns.

First, the EIP is to be administered by a committee consisting of two or more Board Members (the "Committee"), who will have broad powers to determine:

> [who] receive[s] the Grants; when and how each Grant shall be granted; what type or combination of types of Grant shall be granted; the provisions of each Grant (which need not be identical), specifically including any performance criteria and the

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[5] Undefined terms in this section are defined in PREMERA's documents governing equity compensation, a copy of which is attached in Appendix I.

[6] Description of Stock Ownership Plans, Form A: Exhibit G-10 (Oct. 25, 2002), *available at* http://www.insurance.wa.gov/special/premera/filing/Exhibit_G-10.pdf [hereinafter "Plan Limitations, Form A: Exhibit G-10"].

> time or times when a person shall be permitted to receive Common Stock pursuant to a Grant; and the number of shares of Common Stock with respect to which a Grant shall be made to each such person.[7]

Moreover, the Committee's decisions are final, and no person may review the decisions.[8] Because there is no oversight as to the decisions made by the Committee, there is a potential that excessive Grants, or Grants with extremely favorable terms, could be awarded by the Committee to certain executives or Board Members. Second, there are no limits imposed as to the number or type of Grants that each individual can receive during the first two years, let alone thereafter.[9] Thus, the terms of the EIP make possible that certain individuals would be awarded what might be found to be excessive Grants. Third, the EIP does not specify any limit on the magnitude of the share reserve after the first two years following the conversion.[10] After this two-year period, the potential exists for the share reserve to be increased substantially in order to effectively offset any limitations imposed during the initial two-year period. For example, if PREMERA limits the Grants to 1000 shares of common stock during the first two years, but in reality, but for the regulatory process, would have issued 2000 shares, PREMERA could vote to increase the share reserve in the third year by 1000 shares. There are no safeguards to protect against any such potential increase, which is even more concerning because PREMERA's management will effectively maintain voting control over New PREMERA for some time to come. Thus, unlike most publicly-traded companies, the management of New PREMERA need not concern itself unduly about the prospect of dissatisfied stockholders electing directors who will reverse such decisions, or even replace them. For some time to come, PREMERA's current directors and management (or their appointed successors) will effectively control the company. In addition, the EIP allows for Grants to be made as early as three months after the Transaction is approved, compared to the more typical time frame of between six months and two years found in other similar transactions.

a. Stock Options

A Stock Option gives the holder of the option the right to purchase a certain number of shares of common stock in the future at a price (the "exercise price") that is predetermined on the date of the grant. Thus, the Stock Option has a positive value on the date that the holder's rights are exercised only if the fair market value of the stock on the exercise date is greater than the exercise price. Even if a Stock Option is granted, a holder may not have access to the value of the Stock Option unless the option is vested, although vesting provisions might not be mandatory under the

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[7] Plan, *supra* note 1, § 3(c)(i), at 1 [CONFIDENTIAL].

[8] *Id.* § 3(d), at 2.

[9] *See id.* § 5(a), at 2.

[10] *See id.* § 4(a), at 2.

Plan.[11] The vesting provisions could be accelerated.[12] For options issued during the two-year period following the conversion, vesting will occur in four equal annual installments.[13] Thus, for Stock Options granted during the initial two-year period, an employee could potentially receive half of the value of those underlying shares by the end of the second year after the conversion. Moreover, at the end of the two-year period, when the limitations imposed by Exhibit G-10 are no longer in effect, the Committee could accelerate the remaining vesting provisions so that the holder has access to 100 percent of the value of the Stock Option at that time. There are no safeguards to preclude this acceleration.

In addition, PREMERA has provided for favorable vesting provisions upon retirement. If an employee retires, then his or her options vest automatically.[14] If a Board Member's service is terminated because he or she has served the maximum number of terms, then those options also vest automatically.[15] Because of these retirement/termination provisions, some executives who have satisfied, or will soon satisfy, the qualifications required for retirement could, in effect, retire shortly after the conversion and the Stock Options will be fully vested. In short, they will be "rewarded" not for post-conversion performance, but for having been there at the time of the conversion. Likewise, those Board Members who cannot serve another term will have the opportunity to share immediately in the increased overall compensation.

b. Restricted Stock Grants

PREMERA has the ability to grant common stock to management and Board Members, but restrictions may be imposed on those Grants by the Committee.[16] These restrictions may include the achievement of performance goals for employees, or the completion of a certain period of service for Board Members.[17] Regardless, the Committee may at any time remove or accelerate any restrictions.[18] There are no minimum restrictions that must be imposed upon the Stock Grants, and any restrictions may be removed or accelerated at the Committee's discretion.

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[11] *Id.* § 6(h), at 4.

[12] *Id.*

[13] *Id.*

[14] *Id.* § 6(i)(iii)(A), at 5.

[15] *Id.* § 6(i)(iii)(B), at 5.

[16] *Id.* § 8, at 6.

[17] *Id.* § 8(c), at 7.

[18] *Id.*

c. Stock Appreciation Rights

Stock Appreciation Rights can be granted either together with Stock Options or on a stand-alone basis.[19] Stock Appreciation Rights granted together with Stock Options allow the holder to surrender the options, and to receive in cash the resulting difference between the fair market value of the common stock covered by the option, and the exercise price of the option (*i.e.*, allowing the holder to receive the spread in cash).[20] Stock Appreciation Rights granted on a stand-alone basis do not result in the transfer of equity, although they are conceptually similar to Stock Options. That is, the value of the rights equal the difference between the fair market value of the common stock on the exercise date and the fair market value of the common stock on the date of the grant.[21] However, no stock is ever purchased or sold, but rather, the hypothetical profit is transferred. Many experts refer to this type of hypothetical equity-based incentive as "phantom stock."

d. Performance Units

Performance Units allow the holder to receive Performance Shares or cash when certain performance goals established by the Committee are satisfied.[22] The time period by which these performance goals are to be met must be greater than six months.[23] The Committee can alter the terms of the Performance Units at any time.[24] The Committee is given full discretion in establishing or changing the performance goals. For example, it could lower performance expectations at any time, including during times when management has not achieved their performance goals necessary for the pay-out of these Grants to be triggered. Furthermore, similar to Stock Appreciation Rights, Performance Units payable in cash are not limited by Exhibit G-10 because no actual equity is ever transferred.

3. Exhibit G-10 to the Form A, Entitled "Description of Stock Ownership Plans"

During the first two years after the conversion, the maximum number of shares that can be granted to officers, employees, and Board Members may not exceed seven percent of the shares

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[19] *Id.* § 9(a), at 7.

[20] *Id.* § 9(b)(i), at 7.

[21] *Id.* §9(c)(i), at 8.

[22] *Id.* § 10(a), at 8.

[23] *Id.*

[24] *See id.* § 10(h), at 9 ("The Committee may at any time, in its sole discretion, interpret or clarify any and all performance criteria for a Grant of Performance Units).

issued and outstanding after the IPO (including the shares held by the Foundation Shareholder).[25] At first glance, Exhibit G-10 purports to impose a "Prohibition on Stock Grants" during the first year after the conversion.[26] However, Exhibit G-10 provides for exceptions couched as a "Limitation on Stock Option Grants," but which in reality, may provide lucrative compensation to executives and Board Members.[27] In addition, the supposed prohibitions on stock grants do not seem to apply to Stock Appreciation Rights on a stand-alone basis or Performance Units with payment limited to cash, neither of which requires the actual transfer of equity. During the first year, non-officer employees may receive stock options with underlying shares up to 1.5 percent of the total number of shares issued and outstanding,[28] which approximates 20 percent of the seven percent maximum share reserve. Another "limitation" during this period is that New PREMERA may make additional grants to officers, employees, and Board Members not to exceed 2.8 percent of the total number of outstanding shares,[29] which equals 40 percent of the share reserve. Thus, the Committee could grant awards totaling approximately 60 percent of the share reserve within the first year following the IPO. There are no "limitations" on grants during the second year after the IPO; thus, the remaining 2.7 percent of the share reserve could be allocated to officers and Board Members during that period.

Exhibit G-10 also suggests that two provisions will be adopted in order to satisfy applicable law or stock exchange listing rules with respect to shareholder approval of stock plans.[30] PREMERA adopts one provision in particular, however, which seems to give it the ability to circumvent the very "prohibitions" and "limitations" of Exhibit G-10. That provision implies that third-party stockholders (stockholders other than the Foundation Shareholder) by majority vote can compel New PREMERA to amend any existing stock plan.[31] This could be read to mean that the current limitations could be amended before the two-year restriction period in Exhibit G-10 expires. On the other hand, if this provision were to apply after the limitations period, it would provide some safeguard against potential use by PREMERA's management and Board Members of their voting control over the Foundation Shareholder in order to benefit themselves. But, it seems that these provisions are effective only to the extent imposed by stock exchange listing rules. Based on the information currently available, PREMERA's intentions remain unclear.

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[25] Plan Limitations, Form A: Exhibit G-10, *supra* note 6, § (l) at 2.

[26] *Id.* § (3)(a), at 2.

[27] *See Id.* § (3)(b), at 2-4.

[28] *Id.* § (3)(b)(i), at 3.

[29] *Id.* § (3)(b)(ii), at 3.

[30] *Id.* § (4), at 4.

[31] *Id.* § (4)(b) at 4.

D. Compensation

Assuming *arguendo* that the weaknesses in these provisions are resolved so as to prevent abuse or unintended consequences, the question remains as to whether the additional compensation to be received by management or the Board Members is either unreasonable or that it may have contributed to the decision to convert. Although PREMERA has adopted the SOP, it has not specified the amount of additional compensation that each executive or Board Member will receive. Thus, the Commissioner will not be able to determine whether an unreasonable amount of compensation will inure to one or more executives or Board Members. Mercer Human Resource Consulting ("Mercer"), however, provided its recommendations to PREMERA on October 17, 2003, and C&B will consider those recommendations as if they manifested the intent of PREMERA's management. If management, instead, intends for awards to be materially different from those suggested in the Mercer presentation, it is incumbent upon company officials to fairly advise the Commissioner of their plans. In any event, as a starting point, the amount of compensation that management receives should be subject to the non-inurement restrictions on nonprofit corporations.

1. Non-inurement Provisions of Nonprofit Corporations

A RCW Chapter 24.03 nonprofit corporation, such as Premera Blue Cross, may pay compensation in a reasonable amount to its members, directors, or officers for services rendered,[32] but may not make any distribution of income to such persons.[33] A RCW Chapter 24.06 nonprofit corporation, such as PREMERA, may fix compensation for its officers and agents,[34] and although not expressly stated in RCW Chapter 24.06, PREMERA's nonprofit nature necessarily implies that the corporation may not distribute income to officers or directors.[35] The rationale behind the non-inurement restriction on nonprofit corporations flows from the public benefit nature of the organizations. Their purpose fundamentally is not to provide for investor or private gain, but rather to devote their assets exclusively to the fulfillment of social welfare or eleemosynary missions. They are imbued with a fundamental public trust that would be undermined substantially by the ability of management and directors or trustees to derive personally more than reasonable compensation from their operations.

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[32] RCW 24.03.030(4).

[33] RCW 24.03.030(2); *see* RCW 24.03.005(3) (defining a "nonprofit corporation" as "a corporation no part of the income of which is distributable to its members, directors or officers").

[34] RCW 24.06.030(11).

[35] *Cf. Sound Health Ass'n v. Comm'r*, 71 T.C. 158, 159 (1978) ("As a nonprofit corporation, the petitioner cannot, by Washington law, be operated for the personal benefit of any member, officer, or director.").

2. Restrictions on Compensation in the Internal Revenue Code

Washington courts do not appear to have elaborated upon the limits on compensation paid by nonprofit corporations, however, the Internal Revenue Code (I.R.C.) and cases construing it provide some guidance. For example, organizations may be exempt from federal income taxation under I.R.C. §§ 501(c)(3) and 501(c)(4) only so long as no part of their net earnings inure to the benefit of any private shareholder or individual. By further example, pursuant to I.R.C. § 833(c)(3)(A)(vi), a non-Blue Cross Blue Shield health insurance plan may receive the same favorable tax treatment as Blue Cross Blue Shield ("BCBS ") plans if, *inter alia*, "no part of its net earnings inures to the benefit of any private shareholder or individual."[36] The purpose of the non-inurement restriction is to stay the hands of those who are in a position to siphon off the organization's funds for their own benefit.[37] When the nonprofit organization's purposes are sacrificed to the private interests of those in control, the organization is made to serve a private interest.[38] For purposes of these I.R.C. restrictions, compensation constitutes prohibited inurement of a private benefit if the compensation is "unreasonable."[39]

Whether compensation paid by a nonprofit corporation is reasonable or excessive may be determined by reference to criteria similar to those which apply in determining whether compensation paid by a for-profit organization is deductible under I.R.C. § 162.[40] In the context of for-profit corporations, compensation in excess of reasonable compensation for services rendered is subject to disfavored tax treatment; the excess above reasonable compensation being treated as a nondeductible dividend distribution, rather than a deductible expense under § 162.[41] The reasonableness of compensation is a question of fact.[42] Factors considered by the courts in determining whether compensation is reasonable in the for-profit context of § 162 include: (a) the

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[36] I.R.C. § 833(c)(3)(A)(vi).

[37] *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999).

[38] *Sound Health Ass'n*, 71 T.C. at 186.

[39] *See, e.g.*, *Bubbling Well Church of Universal Love v. Comm'r*, 670 F.2d 104, 105 (9th Cir. 1981); *Mabee Petroleum Corp. v. United States*, 203 F.2d 872, 876 (5th Cir. 1953).

[40] *Alive Fellowship of Harmonious Living v. Comm'r*, 47 T.C.M. (CCH) 1134 (1984) (no page numbers available).

[41] *See, e.g.*, *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1242 (9th Cir. 1983); *B & D Founds., Inc. v. Comm'r*, 2001 Tax Ct. Memo LEXIS 298, at *23–25 (T.C. Oct. 3, 2001); *Labelgraphics, Inc. v. Comm'r*, 1998 Tax Ct. Memo LEXIS 345, at *20–21 (T.C. Sept. 28, 1998); *Mad Auto Wrecking, Inc. v. Comm'r*, 1995 Tax Ct. Memo LEXIS 146, at *13–16 (T.C. Apr. 5, 1995).

[42] *B & D Founds.*, 2001 Tax Ct. Memo LEXIS 298, at *24; *Labelgraphics, Inc.*, 1998 Tax Ct. Memo LEXIS 345, at *20; *Mad Auto Wrecking, Inc.*, 1995 Tax Ct. Memo LEXIS 146, at *16.

employee's qualifications; (b) the nature, extent, and scope of the employee's work, including positions held, hours worked, and duties performed; (c) the size and complexities of the employer's business, as indicated by its sales, net income, or capital value; (d) a comparison of salaries paid with the employer's gross and net income;[43] (e) the prevailing general economic conditions; (f) a comparison of salaries with distributions to shareholders and retained earnings; (g) the prevailing rates of compensation for comparable positions in comparable concerns;[44] (h) the salary policy of the employer as to all employees; (i) the amount of compensation paid to the particular employee in previous years;[45] (j) the employer's financial condition; (k) whether the employer and employee dealt at arm's length or whether a conflict of interest was indicated;[46] (l) whether the employee guaranteed the employer's debt; (m) whether the employer offered a pension plan or profit-sharing plan to its employees; and (n) whether the employee was reimbursed by the employer for business expenses that the employee paid personally.[47] Furthermore, a person with influential control "probably cannot escape insider status by formally distancing herself from the wage-setting process," such as by setting up an independent committee.[48]

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[43] Net income is usually more important, because it more accurately gauges whether a corporation is disguising the distribution of dividends as compensation. *B & D Founds., Inc.*, 2001 Tax Ct. Memo LEXIS 298, at *38. No particular ratio between compensation and gross or net taxable income is a prerequisite for a finding of reasonableness. *Id.*

[44] This is also expressed as "a comparison of the employee's salary with those paid by similar companies for similar services." *Elliotts, Inc.*, 716 F.2d at 1246.

[45] Where a large salary increase is at issue, it is useful to compare past and present duties and salary payments. *Elliotts, Inc.*, 716 F.2d at 1245; *Labelgraphics, Inc.*, 1998 Tax Ct. Memo LEXIS 345, at *24. In addition, bonuses not paid pursuant to a structured, and formal program, consistently applied, are suspect. *Labelgraphics, Inc.*, 1998 Tax Ct. Memo LEXIS 345, at *36–37 (disregarding expert testimony that executive's 1990 bonus was reasonable, where it was almost three times the size of his 1988 bonus, even though the company enjoyed significantly higher gross receipts, as well as a substantially higher net profit after taxes, for its 1988 fiscal year than for its 1990 fiscal year). "On the other hand, evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question was reasonable." *Elliots, Inc.*, 716 F.2d at 1247. A contingent compensation formula is not necessarily unreasonable if it "overcompensates in good years and undercompensates in bad years," and it is also "permissible to pay and deduct compensation for services performed in prior years." *Id.* at 1248.

[46] *See Alive Fellowship of Harmonious Living v. Comm'r*, 47 T.C.M. (CCH) 1134 (1984) (no page numbers available) (stating that "[o]ne factor to consider [in determining the reasonableness of compensation] is whether comparable services would cost as much if obtained from an outside source in an arm's-length transaction") (citing B.H.W. *Anesthesia Found. v. Comm'r*, 72 T.C. 681, 686 (1979)).

[47] *Elliotts, Inc.*, 716 F.2d at 1245–48; *Mad Auto Wrecking, Inc.*, 1995 Tax Ct. Memo LEXIS 146, at *17–18.

[48] Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. at 432–33 (1999) [hereinafter "Frumkin & Andre-Clark"]. Frumkin & Andre-Clark go on to state that *United Cancer Council v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999), suggests "that setting up an independent compensation committee will not protect an influential insider from an inurement finding." *Id.* at 433.

3. Comparable Company Analysis

What constitutes "comparable" positions or companies for purposes of executive compensation seems to be a discretionary question on the part of the fact-finder. Courts have rejected expert testimony that failed to provide specifics on the particular executives involved, including both their particular qualifications and skills, and the similarities in the services rendered.[49] Courts have rejected expert testimony that failed to provide specifics on the "comparable companies," including size (annual sales), type of business, number of employees, and business conditions in the areas in which they operate.[50] In determining the array of companies to compare to PREMERA, for-profit companies alone may not be comparable for purposes of evaluating the reasonableness of executive compensation. The following observations may prove helpful in this regard:

> It is often assumed in the old reasonable compensation/private benefit cases, and now with the excess-benefit rebuttable presumption, that comparisons can and should be made between the tax-exempt organization and a "comparable" for-profit corporation. The comparability assumption is problematic because it never even raises the question of how the nonmonetary goals and aspirations of the exempt organization should be factored into the decision-making process. Exempt organizations have nonmonetary, mission-driven goals and the outcomes are sometimes intangible, unmeasurable, and even unknown. . . . Further, some have argued that exempt organizations provide nonmonetary rewards for employees which are different from those provided by a for-profit company. These include personal fulfillment and growth opportunities, flexible lifestyles, and, in some cases, prestige from being associated with the nonprofit entity (for example, physicians in teaching-hospital settings).[51]

This may explain, for example, why the position of President of the United States attracts qualified candidates, even though the monetary compensation for serving in this public sector (*i.e.*, nonprofit) position is far lower than the compensation typically paid to the CEO of a large private sector (*i.e.*, for-profit) organization. Indeed, in 1997, the Office of Oversight and Investigation, Council of the City of New York, conducted a study of executive compensation in nonprofit

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[49] *Labelgraphics, Inc.*, 1998 Tax Ct. Memo LEXIS 345, at *28–29.

[50] *B & D Founds., Inc.*, 2001 Tax Ct. Memo LEXIS 298, at *54–55.

[51] Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TUL. L. REV. 819, 856–57 (1997); *see* Frumkin & Andre-Clark, *supra* note 48, at 471 (arguing that allowing a nonprofit corporation to compare compensation of its management to that of for-profit companies "is problematic because it threatens to undermine the fragile identity of [nonprofits] as service and mission-driven organizations where motives and rewards cannot be measured in terms of dollars and cents").

organizations contracting with New York City.[52] The three methods of analysis selected were: (1) comparison to compensation paid by other nonprofits of similar size; (2) comparison to salaries received by government officials responsible for delivering public services, such as the Mayor of New York City and the commissioners of several of the city's agencies; and (3) comparison to the median compensation paid to executive directors of nonprofit organizations of similar size, including a calculation of compensation as a percentage of the organization's total functional expenses.[53] The study made use of a survey conducted by Abbott, Langer and Associates (the "ALA Survey"), an independent management consulting firm known for its surveys of nonprofit organizations across the country.[54] The ALA Survey was selected because of its comprehensive sample size and its widespread use by compensation specialists.[55] Regional differences in compensation levels were also taken into account.[56] There is precedent in compensation analysis, therefore, for limiting organizations "comparable" to a nonprofit corporation to other nonprofit entities.

4. Current Compensation of PREMERA's Management and Board as Compared to Comparable Nonprofit Companies

PwC has analyzed whether the compensation paid to PREMERA's management and Board is excessive as compared to other similarly situated nonprofit companies.[57] Although the use of only nonprofit comparable companies could be viewed as being appropriate, PwC believes that combining nonprofit health insurers with for-profit insurers in the peer group would be reasonable given the fact that PREMERA competes directly with some for-profit insurers. Moreover, because PREMERA is a BCBS company, it would also be logical to compare PREMERA to its comparable BCBS counterparts,[58] which also include for-profit and nonprofit companies. These two sets of comparable companies are referred to as the "Health Industry Survey Group," and the "BCBS Survey Group," respectively.

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[52] OFFICE OF OVERSIGHT & INVESTIGATION, COUNCIL OF THE CITY OF N.Y., REPORT: TO PROFIT OR NOT-TO-PROFIT: AN EXAMINATION OF EXECUTIVE COMPENSATION IN NOT-FOR-PROFIT ORGANIZATIONS CONTRACTING WITH NEW YORK CITY (1997), *reprinted in* 25 FORDHAM URB. L.J. 471 (1998).

[53] *Id.* at 482–84.

[54] *Id.* at 483.

[55] *Id.*

[56] *Id.* at 488–90.

[57] PwC, Executive Compensation Review: Competitiveness and Reasonableness of PREMERA Practices, at 3-4 (Oct. 27, 2003), available at http://www.insurance.wa.gov/special/premera/reports/OICFinal/PWC_Executive CompensationRev.pdf [hereinafter "PwC Executive Compensation Report"].

[58] PREMERA has used comparisons to BCBS companies for other issues such as the level of risk-based capital to maintain.

In comparing the compensation of the top five executives to the Health Industry Survey Group and the BCBS Survey Group, PwC concluded that the total direct compensation for each executive was near the 75th percentile, with the exception of the Chief Legal/Policy Officer and the Chief Actuary, who were above the 75th percentile.[59] In addition to the foregoing analysis, performance of a company as compared to the performance of other companies can be indicative of whether a company's executive compensation practices are reasonable. In making this comparison, PwC has collected key financial data from the A.M. Best Company database for a group of BCBS companies (the "Performance Peer Group") from 1999-2002.[60] In this analysis, PwC has concluded that the Chief Legal/Policy Officer and Chief Actuary received above market total direct compensation as compared to the relative performance of PREMERA.[61]

Although it appears that the compensation paid to two members of PREMERA's management team is excessive, the question for the Commissioner to decide is whether the additional compensation that management stands to gain influenced inappropriately the decision to convert, or is otherwise not in the public interest. Therefore, it is also important to determine whether PREMERA's compensation with the additional equity incentives is excessive.

5. Mercer's Recommended Compensation to be Paid to PREMERA's Management and Board as Compared to For-profit Comparable Companies

Typically, in a publicly-traded company, the public market favors management compensation that is in line with management in other comparable for-profit companies, especially compensation that is based on incentives such as stock options. In fact, sophisticated investors gain confidence from the alignment of management's interests with their own interests through stock incentives and similar plans. Conversely, if management is not compensated reasonably, then the value of New PREMERA's shares may actually be reduced to the extent that the public market believes that management does not have a sufficient incentive to maximize profits, or that the company is unable to attract management of sufficiently high caliber. Investors will prefer that management's interests be aligned with stockholders' interests to the greatest extent possible in order to maximize shareholder value. Therefore, a comparison of PREMERA's compensation to publicly-traded for-profit health insurers is appropriate.

PwC has also analyzed PREMERA's compensation practices with the additional equity-based incentives as compared to publicly held health insurers with median total revenues and

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[59] PwC Executive Compensation Report, *supra* note 57, at 11.

[60] *Id.* at 4.

[61] *Id.* at 14.

membership of $4.2 billion and two million members, respectively ("Compensation Peer Group").[62] PwC has concluded that total direct compensation for management is below the median for the Compensation Peer Group,[63] which is reasonable given PREMERA's size as compared to the comparable companies.

Even assuming that the compensation of PREMERA's officers and directors is currently reasonable by nonprofit standards, and that their compensation by New PREMERA will be reasonable by for-profit standards, a conflict of interest may exist. Because of the fundamental difference in the natures of for-profit and nonprofit corporations, it is likely that PREMERA's officers and directors expected to receive higher compensation from for-profit New PREMERA than from nonprofit PREMERA. This could be considered a conflict of interest tainting the decision to convert from a nonprofit corporation to a for-profit corporation. Such a conflict of interest may by itself justify disapproval of the Transaction.[64] Ultimately, it is important to ascertain whether this expectation of personal gain influenced improperly the decision to convert. Unfortunately, the documents made available by PREMERA do not suffice to dispose of this issue.

6. Difference Between the Current Compensation and Mercer's Recommended Compensation to be Paid to PREMERA's Management and Board upon Approval of the Transaction

To complete our analysis of conflicts of interest and self-dealing, we must analyze the following distinct question: What does management and the Board stand to gain from the approval of the Transaction? If management and the Board were not to receive additional compensation, then arguably very little is to be gained from this Transaction for management and Board Members, and thus, it might be assumed that only PREMERA's best interests (or those of its policyholders and the public) were in mind. But, that is not the case. Both management and Board Members will realize significant financial gains.

Mercer presented to PREMERA's Compensation Committee recommendations as to the compensation levels for each executive, as well as suggested Grants. Mercer compared the compensation levels of PREMERA's nonprofit management and directors to the levels of for-profit

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[62] PwC, Executive Compensation Review: Addendum—Competitiveness and Reasonableness of PREMERA Form A Exhibit G-10 and Equity Incentive Plan, at 7 (Nov. 2003) [hereinafter "PwC Addendum"] (on file with C&B) [CONFIDENTIAL]. For the definition of the "Compensation Peer Group," see PwC Executive Compensation Report, *supra* note 57, at 4.

[63] PwC Addendum, *supra* note 62, at 7.

[64] *Cf.* RCW 70.45.070(4) (providing that an acquisition of a nonprofit hospital by a for-profit entity may not be approved unless "[n]o conflict of interest exists related to the acquisition, including, but not limited to, conflicts of interest related to board members of, executives of, and experts retained by the nonprofit corporation, acquiring person, or other parties to the acquisition").

comparable companies. If Mercer's recommendations are adopted, by virtue of changing PREMERA from a nonprofit company on one day to a for-profit company the next day, PREMERA's management and directors stand to receive the following "raises": (1) the compensation of Brereton ("Gubby") Barlow, President and CEO, would increase from approximately

PROPRIETARY MATERIAL REDACTED

[65] As the Mercer presentation shows, PREMERA's executives have a substantial incentive to pursue a conversion and IPO. Management is not the only group that will benefit financially. Board Members will see significant financial benefits because compensation will increase from $44,500 per member to $119,500, which nearly triples each member's previous compensation.[66]

It could certainly be argued that a merger, as opposed to an IPO, would provide even greater compensation to management and the Board, and yet the merger option was rejected. But as management has indicated previously, a merger would involve a much more arduous regulatory process. And such a merger would entail a surrender of at least some independence and, therefore, control over future employment and benefits. Moreover, there will be nothing to prevent PREMERA's management and Board Members from receiving the benefits that are available currently through the IPO, and then later reaping the benefits of a subsequent merger with WellPoint or another suitor under a much *less* arduous regulatory process, because PREMERA will have already converted into a for-profit company. The foregoing scenario is not unique – there are several examples where BCBS companies converted into for-profit companies, conducted IPOs, and then a few years later were acquired by Anthem or WellPoint.[67]

But, as discussed earlier in Section II.D.5, some compensation tied to equity is important to maximize the value of the shares for the Foundation Shareholder. Thus, a balance between the interest of maximizing the value of the shares, while at the same time lessening any inurement to management and the Board must be found, if available. A key element of that balance might be to

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[65] Mercer Presentation, *supra* note 1, at 13 [CONFIDENTIAL]. The total direct compensation calculations by Mercer are slightly different than those of PwC.

[66] *Id.* at 14.

[67] See, for example, the Trigon BCBS (Virginia) IPO in 1997 and merger with Anthem in 2002, or the COBALT BCBS (Wisconsin) IPO in 1999 and merger with WellPoint this year.

assure that incentives are tied to post-conversion performance, and do not simply reward "being there" at the time of conversion. Imposition of waiting periods following conversion, before the end of which no such incentives may be awarded, has been deemed in some instances to serve this goal. Such delays typically range from six months to one or two years. Such a delay would help ensure that management's integrity has been preserved prior to, and after, this process while at the same time enabling management and the Board to have an incentive to maximize share value. Moreover, a procedure could be instituted whereby any benefits or additional increases to compensation of existing management and the Board (not to new members and executives) would be reviewed by an independent committee selected by the Commissioner. In addition, the unfettered independence and discretion of the proposed two-member Compensation Committee may itself create an easily remediable substantial problem. In sum, although the "raise" that each executive and Board Member will receive is significant, there is not enough evidence to conclude that the prospects of such raises improperly influenced the conversion decision. But the magnitude of these increases in compensation, combined with the possibility of substantial stock options or similar incentives, certainly provides a basis for concern.

III. CONCLUSION

On the record available for this review, it is not possible to resolve dispositively the question of whether expected compensation and incentives played an improper role in the decision to convert. It is clear that the conversion can, and likely will, result in substantial personal gain to PREMERA's management and directors. Some of these gains will depend on the ability of management to drive up the price of the company's stock after conversion. Achieving this goal may not always be most consistent with the best interests of policyholders, insureds, and the public. Other benefits may be available simply as a result of being associated with PREMERA at the time of conversion.

The SOP include a number of features that could lead to unreasonable or abusive levels of compensation for executives and Board Members. The fact that there is no oversight over the Committee's decisions may result in potentially excessive grants with extremely favorable terms to be issued by the Committee to certain executives. Certain executives or Board Members may receive excessive Grants because there are no limitations imposed per individual as to the number of Grants that each may be allowed to receive during the first two years, or subsequently thereafter. After the initial two-year period during which the share reserve is limited, the potential exists for the share reserve to be increased in order to offset effectively any limitations imposed during the two-year period.

For Stock Options granted, an employee could potentially receive half of the value of those options by the end of the second year after the conversion. The retirement/termination provisions provide for accelerated vesting of the options of executives and Board Members. These retirement/termination provisions may not be in the public interest because some executives who have satisfied, or will soon satisfy, the qualifications required for retirement could, in effect, retire shortly after the conversion with their Stock Options fully vested. Likewise, those Board Members that cannot serve another term will have the opportunity to share in the increased overall compensation shortly after the conversion.

The Committee determines the restrictions, or lack thereof, to impose upon the common stock that it grants. These restrictions may include the achievement of performance goals for management, or the completion of a certain period of service for Board Members. Regardless, the Committee may at any time remove any restrictions including vesting restrictions. There are no minimum restrictions required to be imposed upon the Stock Grants, and any restrictions may be removed at the Committee's discretion.

Stock Appreciation Rights can be granted in connection with Stock Options or on a stand-alone basis. Stock Appreciation Rights granted in connection with options allow the holder to surrender the options and to receive in exchange the difference between the fair market value of the common stock covered by the option and the exercise price of the option. Stock Appreciation Rights granted on a stand-alone basis allow the holder to receive the difference between the fair market value of the common stock on the exercise date and the fair market value of the common stock date of the grant, without the actual exchange of equity.

Performance Units allow the holder to receive Performance Shares or cash when certain performance goals established by the Committee are satisfied. The Committee may reduce performance expectations during times when management has not achieved their performance goals necessary for the pay-out of these Grants to be triggered. Morever, Performance Units payable in cash and Stock Appreciation Rights on a stand-alone basis are not subject to the limitations imposed by Exhibit G-10 because they are "phantom stock." That is, no equity is actually granted.

Compensation currently paid to PREMERA's management and Board Members appear reasonable in comparison with other companies, with the possible exception of two executives (whose jobs may actually differ from those against which they are compared). Mercer's proposed recommendations as compared to publicly-traded companies appear reasonable given PREMERA's size. However, the potential increase in compensation is significant for management and Board Members ranging from [ ] percent in increases for the top five executives, totaling in the aggregate approximately [ ] and an increase of [ ] for each Board Member's compensation. Nonetheless, these increases in equity-based compensation can be reasonable and necessary in order to maximize shareholder value.

PROPRIETARY MATERIAL REDACTED

In light of these observations, the Commissioner may want to consider the significance of the inability to ascertain the extent to which expected compensation played a role in the conversion decision. He may also want to consider the desirability of such broad, unsupervised, discretion for the proposed Compensation Committee. Similarly, the Commissioner may wish to evaluate the desirability of incentives that, effectively, may be awarded for pre-conversion tenure or performance. Finally, the magnitude of potential or contemplated compensation increase may itself deserve substantial attention. In the absence of appropriate restrictions or safeguards, the

Commissioner may conclude upon such analysis that, in combination, these concerns raise substantial issues as to the possibility of a conflict of interest, self-dealing, or failure to satisfy the public interest.